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HAPPY 15TH ANNIVERSARY TO A STELLAR PERFORMER...

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Investment Age

The newspaper of corporate and institutional investing

Congress ups reversion tax

By Joel Chernoff

WASHINGTON — Caving in to pressure by Sen. Howard Metzenbaum, D-Ohio, the Treasury Department has announced a six-month freeze on issuing determination letters affecting terminations of overfunded defined benefit plans.

Congress also agreed to a permanent increase to 15% from 10% in the excise tax imposed on reversions of surplus assets to employers, but rejected a temporary 60% excise tax sought by Mr. Metzenbaum. The provision, contained in a technical corrections bill, is expected to be signed soon by President Reagan.

Photo by Tom Reed

Sen. Howard Metzenbaum succeeded in obtaining a permanent increase in the surplus asset reversion excise tax as well as a six-month freeze on determination letters.

Employers frequently seek the Internal Revenue Service's blessing in the form of determination letters on such matters as plan amendments or terminations to ensure any changes adhere to tax law.

According to sources, Mr. Metzenbaum forced Treasury officials to agree to the freeze when he blocked ratification of a tax treaty between the United States and Bermuda Oct. 22, in the waning hours of the 100th Congress. The freeze does not require legislative approval.

During the time the freeze is in effect — Oct. 24, 1988, through May 1, 1989 — the Treasury Department and Congress will pursue the issues.

"This moratorium will give Congress time to come up with legislation that will make certain workers and retirees get a fair share of those funds," Mr. Metzenbaum said in a press release. He noted employers have obtained $19 billion in surplus assets from their pension plans since 1981

The freeze includes a broad exemption for terminations

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Equity sales binge of plans shows no signs of abating

By Fred Williams

Private pension plans have liquidated more than $284 billion worth of stocks from 1985 through the second quarter of 1988, according to Federal Reserve Board flow of funds data.

Using annualized figures as "rough estimates," Salomon Brothers Inc., New York, estimates net equity retirements for the four years ending 1988 could reach $331 billion.

Corporate pension plans have been net sellers of common stocks every year since 1985 and equity levels are at their lowest percentage of financial assets in 25 years, according to several Wall street financial analysts.

The selling of equities by private pension funds occurred at a record rate during the first quarter of this year with net liquidations totaling $40.7 billion. The trend continued into the second quarter of 1988, with stock sales totaling $22.9 billion, according to the Fed

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Clockwise from top right: Joe Scarella, investment consultant, Wyatt Asset Services; Suresh Bhirud, chief investment strategist, Oppenheimer; Charles Clough Jr., chief investment strategist, Merrill Lynch Capital Markets.

Ameritech blazes trail in rate swap

By Mike Clowes

CHICAGO — The $12 billion American Information Technologies Corp. pension fund has invested $100 million in a unique interest rate swap — exchanging a short-term variable-rate investment for a longer-term variable-rate indexed-based return.

The investment in the BIG Index Swap program, offered by Salomon Brothers Inc., New York, was made without assets actually changing hands, said Don Phillips, director-investment management at Ameritech.

The $100 million committed was part of the approximately $500 million Ameritech normally has in residual cash. This cash usually is invested in short-term securities.

Ameritech has contracted to pay Salomon Brothers the London interbank offered rate minus a spread, a short-term rate, on the $100 million and, in return, Salomon has contracted to pay Ameritech the total return of the Salomon Broad Investment Grade Index rate.

While neither Ameritech nor Salomon would say how much less than LIBOR Ameritech would pay, a typical spread now would be 20 basis points, said Richard Stuckey, director of hedge management at Salomon Brothers.

Each month, the difference between the rate paid by Ameritech and the rate paid by Salomon Brothers will be calculated on the $100 million. If the BIG Index total return is higher than the LIBOR rate minus the agreed upon spread, Salomon will send Ameritech the difference. If the index return is less than LIBOR minus the spread, Ameritech will send Salomon the difference. These monthly checks are the only amounts that will change hands between Ameritech and Salomon.

Because Ameritech already had $500 million in short-term investments throwing off a return similar to the LIBOR, it didn't have to make any changes in its investments to participate in the swap. It merely agreed to swap part of the returns from these short-term investments for the total return on the BIG Index.

Salomon Brothers introduced the swap as a simple way for investors to create a synthetic bond index fund that will match or beat the BIG Index return. The firm envisaged the swap as a simple and inexpensive way for pension funds to establish a core fixed-income portfolio.

At the same time, because Salomon pays the investor the total return on the BIG Index, most of the bonds of which Salomon has in inventory, the new vehicle serves as a way for the

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LATE NEWS

TIAA-CREF relaxing transfer rule

WASHINGTON — The Teachers Insurance and Annuity Association — College Retirement Equities Fund has agreed to broaden fund transferability for participants as a result of its requests for exemptions under the Investment Company Act of 1940 for a recently introduced money market fund.

The agreement was reached with several higher education institutions and associations, a number of mutual fund companies and the Investment Company Institute. The organizations intervened when TIAA-CREF requested exemptions from the Securities and Exchange Commission regarding transferability and limiting the voting rights of participants in the money market fund.

TIAA-CREF "agreed in principle that a CREF transfer option will be developed to permit CREF participants to transfer existing and future accumulations to alternative funding vehicles that their employers may permit and to elect to take lump-sum distribution of accumulations, again if allowed by the employer's plan," said Clifton R. Wharton Jr., chairman and chief executive officer of the $66 billion system.

Details will not be released until Nov. 21.

Ariel sets new-cash moratorium

CHICAGO — Ariel Capital Management Inc., Chicago, has notified its 50 clients it is capping its accounts and, for an indeterminate time beginning Feb. 1, no longer will accept additional money into its separate accounts.

The notice follows by about a year a pronouncement that Ariel would not seek new clients. The decisions don't affect Ariel's mutual fund, run through the Calvert Fund.

The moratorium reflects a concern that Ariel's portfolio of primarily small-capitalization stock is getting too large, said Darice Wright, Ariel senior vice president. Ariel has about $550 million under management and expects by Feb. 1 to have about $600 million, she said. It invests in 30 stocks.

Fed official moving to NACHA

WASHINGTON — Elliott C. McEntee, associate director of the division of federal reserve bank operations at the Federal Reserve Board, has been hired as the president and chief executive officer of the National Automated Clearinghouse Association.

Mr. McEntee, a familiar name to most corporate cash managers and bank cash management executives because of his senior level involvement in the Fed's efforts to squeeze float and eliminate risks from the payment system, will replace William R. Moroney, who will leave NACHA at the end of 1988.

Mr. McEntee has worked for the Federal Reserve Board since 1973, most recently managing the Fed's oversight of the domestic payment mechanism and the financial services that Federal Reserve Banks offer U.S. financial institutions.

Fixed-income manager moves

LONDON — Christopher Wyke, formerly an international fixed-income manager at N.M. Rothschild International Asset Management, London, has joined Bankers Trust Investment Management Ltd., London, as a director and head of fixed income.

Mr. Wyke spent seven years with Rothschild, which lost seven investment professionals about a year ago (*Pensions & Investment Age*, Sept. 7, 1987). From 1984 to 1987, Mr. Wyke managed Rothschild's New York office with responsibility for working with pension plans and captive insurance companies.

Rothschild replaced Mr. Wyke internally, although the replacement's name could not be learned by press time.

Stormont-Vail switches advisers

TOPEKA, Kan. — Stormont-Vail Health Services Corp. hired Dean Investment Associates, Dayton, Ohio, as balanced manager for its entire $13 million pension fund and $3 million in general operating funds, said Vernon Long, vice president.

Dean replaces Reimer and Koger Associates Inc., Shawnee Mission, Kan., which also ran a balanced account, according to Mr. Long.

Shearson Lehman Hutton Inc., Kansas City, Mo., was the consultant in the move.

Derivative plays lure bond assets

By Trudy Ring

Fixed-income managers that use futures and options are seeing a boom in business — picking up almost $2 billion this year alone — in marked contrast to the post-crash market for equity derivative strategies.

Among the managers seeing a spurt in business during 1988 are Lotsoff Capital Management, Chicago, whose assets under management have doubled to $800 million; Pacific Investment Management Co., Newport Beach, Calif., whose assets have grown by about $1 billion to $17.5 billion; Ward & Wissner Capital Management Inc., New York, whose assets have grown to about $800 million from $577 million; and Security Capital Management Inc., Stamford, Conn., whose assets have grown to $850 million from $561 million.

For all but Lotsoff Capital, the assets are largely tax exempt; for Lotsoff, about half the total is tax exempt, with the remainder from corporate cash and insurance company clients.

The increases came from new clients and increased commitments from existing clients.

The $220 million Equifax Inc. defined benefit plan, Atlanta, increased its allocation to Lotsoff Capital by "a significant amount" this year, said Roger Dailey, vice president. He would not give the exact figures.

Lotsoff Capital has been a manager for Equifax for several years, Mr. Dailey said. "They've basically done a good job for us, they're flexible and they're pretty innovative," he said.

Lotsoff Capital's assignment for the fund includes short-, intermediate- and long-duration strategies, with options used for downside protection.

The Madison, Wis.-based Credit Union National Association's $110 million money purchase plan increased its account with Ward & Wissner by about $8 million, to roughly $20 million this year. Ward & Wissner is one of five managers for the plan's fixed-income fund.

After participants direct their contributions to a certain fund, trustees decide which manager within the fund will receive the dollars, said Jim Cox, investment consultant for Credit Union Benefit Services Inc., the affiliate that

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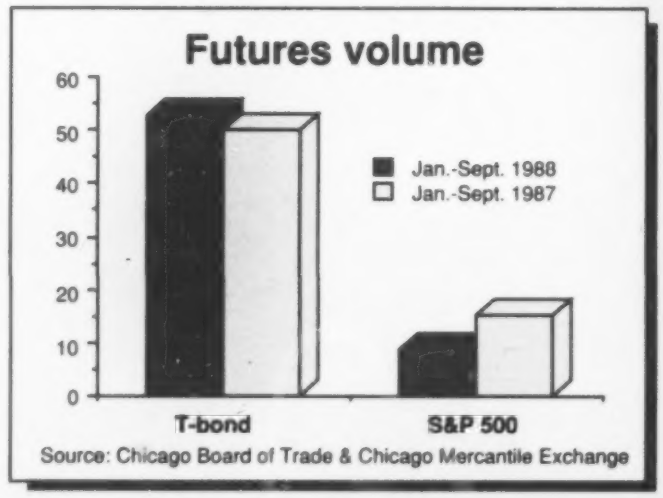

Searches up slightly

Fund allocation reviews spark activity

By Carol Wiley

Pension funds are searching for managers at only a slightly higher rate this year than during the pre-crash months of 1987, with most manager changes being precipitated by post-crash scrutiny of asset allocations rather than dissatisfaction with performance.

Pension funds also are using consultants slightly more often than last year in their searches, according to one firm's data.

A total of 612 managers searches have been conducted between Jan. 1 and Sept. 30, according to Eager Associates, Louisville, Ky. Of the total, 370 used consultants, 145 didn't or wouldn't indicate consultant use and 97 were conducted in-house. The searches resulted in 250 hirings.

During the same period in 1987, 551 manager searches were conducted. Of those, 313 made use of consultants, 69 searches didn't or wouldn't indicate consultant use and 169 searches were conducted internally. The searches resulted in 249 hirings.

For the first nine months of 1988, 56 consulting firms were used; in 1987, 48 firms were used.

Fewer searches this year were for defined benefit plans, according to Caroline Cummings Eager, partner in the consulting firm. In the first nine months of 1988, 36% of the searches were for defined benefit plans; in the same period in 1987, 40% were for defined benefit plans.

"We see pension funds hiring fewer specialists and moving to consolidate the number of managers," Ms. Eager said.

The number of searches for public funds increased, however. A total of 35% of the searches from January to Sept. 30 were for public funds; 30% of the searches in the same period last year were for public funds, Ms. Eager said.

In a spot check of 10 investment management consultants, many said most of the manager searches they've conducted this year were the result of analysis of the fund's asset allocation.

One gave Financial Accounting Standards Board regulations as a reason pension funds have been

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Investing for the future

3 traditional factors determine investment results

By Robert D. Milne

The success of any long-term investment program will depend upon the major forces that will be at work through 2003.

Investment returns in the future will be dependent upon the same three major forces that have governed since the dawn of investing: the supply and demand for capital; the economic and political environments; and the ability of corporate America to cope with these environments.

Supply/demand for capital

Looking first at demand, in 1960 the debt load increased at a 6% annual rate. The appetite for borrowing, however, has grown until it has reached levels above 10% in the 1980s.

The reasons for this increase are many, but they boil down to three major categories: the federal budget has gotten out of control; business has gone on a borrowing binge; and the consumer has been lulled into ever-increasing debt in all categories.

Are these factors likely to change greatly? Probably not. In each instance, the fundamental reasons are mostly psychological and are ingrained. Obviously, there are some limits to borrowing and the annual percentage change in debt can't go on increasing forever. In fact, total debt in this country is now more than 170% of gross national product, a higher debt load than in 1929.

In the history of most nations, however, the trend toward greater borrowing rarely has been reversed.

Looking at the supply side, for the first half of the past 25 years, the personal saving rate was about equal to the increase in the debt load. The trend during the past decade has been disappointing, with the personal saving rate falling to near 4%. If it weren't for pension funds — where the annual contribution is considered as personal saving by the employees — the saving rate picture would be even more dismal.

However, this ignores saving by corporate America in the form of retained earnings — as well as other factors.

The demand for credit has been high and increasing, while the supply of saving has been inadequate. Thus it is not really so surprising the return on U.S. Treasury bills during the past 10 years has been 9.2%, compared with a 3% rate during the preceding 50 years.

Perhaps there is some hope from Washington. Finally, there is some understanding that deficit financing can be overdone as evidenced by the Gramm-Rudman-Hollings Act. However, the federal deficit is running at double the initial Gramm-Rudman-Hollings targets. The commitment to the act isn't especially strong.

Before leaving the topic of supply/demand relationships the obvious must be noted — the demand for credit is supplied in some way. Japan and Europe have been financing almost half the federal deficit.

The Japanese, however, have a financial problem that is about the opposite of ours. They have a personal saving rate around 20%, far higher than is needed for their economy. Naturally this excess supply of savings results in a low price for the Japanese investor — with very low interest rates on Japanese bonds and almost unbelievable price-earnings ratios for stocks. The investor doesn't get treated very well when savings are high.

This excessive savings isn't a near-term problem in this country.

Economic/political climate

National income statistics were first compiled in the 1920s, and at the time corporate profits plus interest earned by all corporations amounted to 6% or 7% of GNP. After the worst of the Depression was over, corporate profits rebounded to the same level.

Despite the many challenges corporate America has faced, profits have held up well.

None of us knows what problems will come in the years ahead, but in the past, business has coped with myriad problems and still earned a reasonable share of the nation's output.

Inflation is no longer a problem now that it has slowed to the 4% level during the past five years, with a dip to even lower levels during the collapse in oil prices. In fact, the problem of inflation has been solved twice during the last decade and six times since World War II.

History shows the value of the dollar moves in only one direction — the only difference being that sometimes the drop is sharp and sometimes it is more moderate. Today, the Federal Reserve and other central banks debase currency in an efficient way.

C. Northcote Parkinson, famed for Parkinson's Law that "work expands to fit the time available," has said "Democracy equals inflation."

If debt in the United States is growing at nearly a 10% annual rate while the economy grows over a full economic cycle about 3%, one might infer the pressures for inflation in this country are for a 7% rate. This is no doubt some overstatement of the fundamental inflation rate in this country, but I believe the relatively low inflation rates of today are unlikely to persist. We are at a cyclical low point and are ready for the next cyclical upswing in inflation.

One of the most important elements of the economic environment is the monetary environment.

When money is tight, the price of money rises. The price of money is the interest rate. Interest rates on U.S. Treasury 91-day bills follow velocity almost immediately, with long-term interest rates following.

Although cyclical swings in Federal Reserve monetary policy are the main force leading the bond market, in the longer term the Fed is likely to provide an adequate amount of money supply to provide for economic activity.

During the last 25 years, the return on equities has averaged about 12%. There is some evidence of an upward drift in returns through 1980 in keeping with the supply/demand relationship for capital discussed earlier.

The acceleration of depreciation that occurred with the first Reagan tax cuts reduced reported earnings and, therefore, the reported return on equity. In any event, earnings reported on corporate tax returns are not likely to be overstated.

In trying to evaluate the prospects for returns on stocks, we know bull markets and bear markets make major actual earnings progress because of the changed supply/demand relationships as long-term interest rates more than doubled from 4.25% in 1960 to exceed the 10% mark in the 1980s.

Had it not been for this major change in interest rates, which affected the market prices for stocks and bonds, it is likely returns on stocks would have approximated the return on equity of the underlying corporations. Incidentally, the S&P 500 is used as the measure of corporate America because it includes more than 80% of the value of all stocks on the New York Stock Exchange.

Summary

The accompanying table indicates the forecasts for the year 2000.

I begin with an estimate that inflation will average 6% during the next 15 years. This is somewhat less than in the past decade and more in line with the record of the 25 years during which inflation proceeded at a 5.5% rate.

Forecasting inflation rates is really attempting to forecast the integrity of our friends in Washington. The winds of inflation will blow hot and cold, with some periods of help from oil-price wars and other periods when outside shocks exacerbate inflation.

The major force at work in a longer period is the need to monetize the national debt once the cost of servicing the debt becomes too burdensome. Interest on the national debt is running at more than $140 billion a year. If the value of the dollar were halved, the effective cost of paying the interest would also drop in half.

Although the process of monetizing the national debt doesn't proceed on a steady pace, in the longer term the national debt has been monetized in virtually every nation. On Sept. 22, 1985, the United States devalued the dollar on the international scene when the trade deficit reached intolerable levels. We will similarly be forced to devalue domestically unless the federal budget can be brought under control.

The forecasts of nominal real returns for 91-day T-bills and relatively small real returns for longer-term bonds follow from experience. I do have a greater sense of uncertainty about these forecasts because the supply/demand relationship for capital might well provide better returns for the long-term investor.

The stock market is likely to earn a rate of return equal to the return on shareholders' equity. The long-term record of the returns to corporate America holding constant as a share of GNP is a strong reason for believing investors in equities will continue to share fully in the longer term growth of America.

The conclusion is that investing in bonds is a vote of confidence in the integrity of our representatives in Washington, while investing in stocks is a vote of confidence in the ability of corporate America to continue to earn a reasonably constant share in the future growth of our economy.

Long-term investors have to make their decision to trust one group or the other; standing pat in U.S. Treasury bills will not get them anywhere. ■

Mr. Milne is president and chief executive officer of Duff & Phelps Investment Management Co., Cleveland.

Robert Milne says investment performance will be determined by three traditional forces.

The past, the future

	1960-1987	1938-'87	1962-'87	1979-'87	1987-2000
Inflation	2.2%	3.2%	5.5%	6.4%	6%
Treasury bills	NA	3.5	6.7	9.2	6
Long corp. bonds	4.8	4.9	6.3	9.7	8
S&P 500	9	9.5	9.9	15.3	12

No slowdown

Continued from page 4

"you can't trust those other guys' numbers. They don't have the standards we have. They're lying." Now there is a vast improvement in accounting standards worldwide.

Fifteen years from now there certainly will be more sophisticated and much deeper markets in terms of hedging abilities. Today, long-dated swaps and long-dated hedges on currencies are very difficult to come by. I am sure that down the road you will be able to do a 15-year currency swap or 15-year hedge as easily as you can do a three-month one today. The markets will be that deep because we will be so much more globalized.

Again, globalization will be more a debt globalization than an equity globalization, so your equity play will be in a different form.

Perhaps de-equitization is happening because the U.S. corporations were somewhat bloated. Living closer to the edge makes people more concerned about their costs. That is a particular problem here, but also in many other countries.

The changes in financing will alter the way investment bankers serve companies. Already, investment bankers are dealing with corporations less on the equity side than on the debt side. Equities, both on the sales side and the trading side, will play a much lesser role in investment banking firms than they have.

Debt new-product development efforts will increase. When you get a truly global market with much more sophisticated hedging products, you certainly have to believe innovation is going to blossom. If you had long-dated swaps, long-dated hedges — currency and interest rates — available in a true global market, there would be a lot more sexy things you could be doing.

The barriers to true globalization are differences in the markets, differences in regulation and differences in trading policies that might trigger disputes between countries that would close down foreign entry or investment.

There also will be changes in the roles of commercial banks. The thin-margined lending business cannot continue. Banks are not going to put billions of dollars at risk for 10 basis points. Whether the fee business will increase I don't know, but the banks will move to more of a bigger margined longer-term lender.

Undoubtedly the U.S. banks will consolidate the way the Japanese have: we will have fewer, but larger, banks.

Under the de-equitization scenario, leasing may blossom. If you believe de-equitization is going to happen, there probably are going to be people still wanting quasi-equity plays, and maybe holding an asset like an airplane is equivalent to an equity play.

That is, those who used to play equities may now play equipment leases as a form of equity.

De-equitization may also argue strongly for real estate. If the equity markets diminish in size, perhaps this lack of availability of stocks will prompt increased use of real estate by investors.

Shorter term, what we are all waiting to see is the impact a major business downturn will have on what we have done in the past five years to the capital structures and the capital markets. That is the global event that will tell us what will happen in the future. This whole thing we have been through could just be the greater-fool theory.

The only thing that will stop this worldwide move to debt is if we come out of the next downturn and all of those companies that have leveraged themselves up have gone bankrupt. ■

Mr. Pope is executive vice president and chief financial officer of UAL Inc., Chicago. This article was written with Mike Clowes.

First Interstate lands 5 funds

LOS ANGELES — First Interstate Bank Ltd.'s trust and investment division has picked up five clients representing approximately $3.2 billion worth of assets.

The five new clients, all of whom hired First Interstate to replace Bank of America as their master trustee, are: The Southern California United Food and Commercial Workers Union and Food Employees, Cypress, Calif., $1.7 billion; Consolidated Freightways Inc., Menlo Park, Calif., $150 million; The Laborers Pension Trust Fund for Northern California, San Francisco, $500 million; The Operating Engineers, Local 3, Northern California, San Francisco, for $800 million of its $1.1 billion in assets; and Advanced Micro Devices Inc., Sunnyvale, Calif., $50 million. ■